Minutes of the Executive Board's monetary policy meeting, No. 3

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TIME: 09.00

PRESENT: Svante Öberg, Chairman
Karolina Ekholm
Lars Nyberg
Lars E.O. Svensson
Barbro Wickman-Parak

Leif Pagrotsky, Vice Chairman of the General Council

Sigvard Ahlzén
Kai Barvèll
Carl-Johan Belfrage
Claes Berg
Heidi Elmér
Jesper Hansson
Ann-Christine Högberg
Andreas Johnson
Anna Lidberg (§1)
Tomas Lundberg
Pernilla Meyersson
Marianne Nessén
Christina Nyman (§1)
Mattias Persson (§1)
Olof Sandstedt (§1)
Lena Strömberg (§1)
Åsa Sydén
Staffan Viotti
Anders Vredin

§ 1. Economic developments

It was noted that Carl-Johan Belfrage and Andreas Johnson would prepare draft minutes of paragraphs 1, 2 and 3 on the agenda for the meeting.

Lena Strömberg of the Financial Stability Department began by presenting recent developments regarding financial stability. The so-called three-month basis spread, which is a commonly-used measure of the market's valuation of credit and liquidity risks, has decreased somewhat internationally and is now back to the same level it was at before the most acute phase of the crisis began in September last year. The companies' access to funding on the capital markets has improved, but the difference in the level of return on corporate bonds and treasury bonds is still high. In Europe, issues of covered bonds have increased at the same time as issues of government-guaranteed bonds have decreased by the corresponding amount, which may be interpreted as an improvement in the functioning of the credit markets. In Sweden, the Swedish banks believe that borrowing by issuing covered bonds is working well but that this is still more expensive than prior to the crisis.

Anna Lidberg of the Monetary Policy Department reported on developments in the financial markets since the Executive Board Meeting on 16 June. There has been a downward shift in yield curves in both Sweden and abroad. The krona initially weakened but has since returned to approximately the same level. Both the pricing of financial instruments and surveys of the views of market participants indicate that the repo rate is expected to remain at a level of 0.50 per cent after today's meeting. Long-term loans to the banks at a fixed interest rate are assumed to be a possible measure that the Riksbank can take.

Anders Vredin, Head of the Monetary Policy Department, presented a basis for the Executive Board's discussion in the form of a draft Monetary Policy Report. He noted that underlying material for this draft in the form of assessments of economic developments in Sweden and abroad had been discussed at the Executive Board meeting held on 16 June. Alternative scenarios were presented at a meeting on 17 June.

Since the previous monetary policy meeting in April, the figure for GDP in Sweden in the fourth quarter of 2008 has been revised downwards. The initial position ahead of 2009 was therefore weaker than anticipated in the assessment made in April. The forecast for GDP growth in Sweden in 2009 has been revised downwards by 0.8 percentage points. The assessment is that growth will be low in 2010 and the forecast for unemployment has been revised upwards slightly to 11 per cent by the end of 2010. There has been an upswing in several economic indicators in recent months, although from very low levels.

Resource utilisation will be lower than normal during the entire forecast period. Inflation will, however, be kept up as a result of weak productivity and a weak krona. The forecast for inflation has been only marginally revised since April. CPI inflation is expected to fall to -0.2 per cent for 2009 as a whole, but will then rise to levels above 3 per cent towards the end of the forecast period. The major shifts in CPI inflation can be explained by the fact that the substantial changes in the repo rate during the forecast period affect the mortgage rates that are included in the CPI. However, the assessment is that inflation measured in terms of the CPIF, that is the CPI with a fixed mortgage rate, will be close to 2 per cent for most of the forecast period.

The forecasts for the repo rate in the draft Monetary Policy Report are based on the repo rate being cut to 0.25 per cent and on the expectation that the repo rate will remain at this level for some time to come. The assessment is that it will be possible to reduce the repo rate to 0.25 per cent without threatening the functioning of the financial markets or the inflation target. The weak economic developments justify a slightly more expansionary monetary policy than was anticipated in April. The repo rate path has therefore been adjusted downwards somewhat for the remainder of 2009 and for 2010, but is unchanged for 2011.

The repo rate path entails a high degree of probability that increases in the repo rate will begin to be made in the third quarter of 2010. The assessment that it will be necessary to increase the repo rate in the autumn of 2010 in line with the forecast in April, despite the fact that the forecast for resource utilisation has been revised downwards and the forecast for inflation remains largely unchanged, is a monetary policy assessment. On the one hand, the repo rate needs to be low for a long period of time in order to stimulate the real economy. On the other hand, it needs to be increased eventually so that inflation does not become too high. Anders Vredin also made it clear that the repo rate path should be interpreted as a mean forecast, that is the probabilities that the repo rate will be above or below the path in the period ahead are judged to be equally large.

The situation on the financial markets is still not entirely normal. In order to improve the chances of monetary policy having the desired effects, it is proposed that the Riksbank lends SEK 100 billion to the banks at a fixed interest rate with a maturity of 12 months. This should contribute to lower interest rates on loans to companies and households.

§ 2. Economic outlook abroad

First Deputy Governor **Svante Öberg** agreed with the picture of international developments presented in the draft Monetary Policy Report. We are now experiencing a global financial crisis followed by an unusually severe recession. In many countries it will take a long time to get back to the same production levels that prevailed before the crisis began. This is mainly because asset prices have fallen significantly and participants in both the public and private sectors will need to adapt their balance sheets to lower levels of wealth and income.

Mr Öberg pointed out, however, that there are also positive signs. One such sign is that the Riksbank has largely stopped revising its forecasts downwards. Since September last year, the Riksbank has gradually revised the forecasts for global growth in 2009 downwards from approximately 4 per cent to around 1 per cent. Now, only a minor downward revision has been made.

Another positive sign is that indicators in several countries have bottomed out or have begun to increase from very low levels. The OECD's economic indicators seem to have bottomed out for major countries such as the USA, Japan and Germany, while they have begun to increase in the euro area as a whole, in China and in India. However, no turnaround is yet apparent in countries such as Russia and Brazil. The latest forecast by the World Bank also indicates that there are major problems in many emerging markets.

A third positive sign is that the fears regarding deflation have abated. Inflation is low and may even be negative during some of the months of this year in both the USA and Europe. However, inflation is expected to be positive next year. Inflation expectations five and ten years ahead as measured on the financial markets in the USA, so-called break-even-inflation, were almost zero at the beginning of the year, but have now risen again to over 2 per cent. Oil prices and other commodity prices have also risen in recent months.

Mr Öberg pointed out that at the monetary policy meetings held over the last 12 months or so his assessment has been that the risks on the downside have been greater than the risks on the upside. It has thus been more likely that GDP growth would be lower than in the main scenario than that it would be higher. Developments have also been weaker than in the main scenario in every case.

Mr Öberg now felt, however, that the risks are more balanced. There is still a risk that development will be weaker than expected. It may take longer than estimated to recover from the financial crisis. It is also possible, however, that there will be a more rapid turnaround than expected if the expansionary fiscal and monetary policies have a real impact and if household and business confidence is strengthened.

Deputy Governor **Lars E.O. Svensson** said that he shared the view of international developments presented in the draft Monetary Policy Report and that he wished to begin by speaking about the green shoots that are currently being discussed among economists and the lessons that can learned from history in this context. The most important lesson is not to withdraw expansionary monetary and fiscal policies too soon. Christina Romer, who chairs President Obama's Council of Economic Advisers, recently pointed out in an article in "The Economist" that the US economy recovered quickly in the years following 1933 but that monetary and fiscal policy was tightened in 1936 and caused an unnecessary recession in 1937-38. Paul Krugman has pointed out how Japan experienced an upswing in 1996, whereupon the country introduced a restrictive fiscal policy and ended up in a long recession once again. The lesson is thus that one should be very cautious about ceasing to conduct an expansionary monetary policy too soon when it appears that the situation is beginning to improve. The risks if the wrong monetary policy is applied are namely asymmetrical when the interest rate is close to zero. If monetary policy is too expansionary it is easy to correct this later by increasing the repo rate path sufficiently, but if monetary policy is too contractionary it is difficult to correct this later as the repo rate path can not be significantly reduced.

Mr Svensson also reminded the meeting that there has been quite a lot of discussion about the exchange rate; what determines it, why the krona is weak and whether it will appreciate. He pointed out that an interesting line of reasoning was presented in the press release issued by the IMF's Article IV delegation following their recent work in Sweden. There has been a substantial fall in the demand for all exports around the world. Swedish exports contain a larger than average proportion of investment goods and durable consumer goods and the demand for these goods has fallen more than the average. The demand for Swedish exports has thus fallen more than the average and it is therefore reasonable that the relative price of Swedish exports is falling. This is partly taking place through a depreciation of the krona. According to this reasoning, the depreciation is thus an equilibrium phenomenon and the means by which Sweden's terms of trade, that is the relation between export and import prices, are adapting to the new demand conditions. How long the krona continues to be weak depends on what happens to the demand for Swedish exports. The demand for investments and durable consumer goods may very well fall behind if there is an upswing in world trade. This line of reasoning widens the perspective on the exchange rate, the factors that determine it and its future fluctuations.

Deputy Governor **Karolina Ekholm** shared the view of international economic developments presented in the draft Monetary Policy Report. There are signs of recovery in some areas of the world. These signs are clearest in Asia where several of the countries are being helped along by economic developments in China. In the USA there are signs of an improvement in the situation on the financial markets. As yet, however, there are no clear indications of a recovery of the real economy. The situation is still gloomy in those parts of the world where Sweden's most important trading partners are to be found, that is primarily Europe and the USA. Ms Ekholm also pointed out that Sweden is not benefiting as much from the recovery in Asia.

She believed that there are several questions marks concerning the development of the real economy in the USA. It is unclear how effective the fiscal policy stimulation measures taken will be when public finances are weakening significantly. There are similar problems in parts of Europe, particularly in the UK. The USA is also experiencing a corrective move towards increased saving. This will, at least for a while, restrict the growth of private consumption. The correction is well needed to counteract the major global macroeconomic imbalances that some observers believe have been a strong contributory factor to the financial crisis and the recession we are now experiencing. From the point of view of the households, it is a question of adapting their balance sheets to a situation where wealth has declined as a result of falling house prices. However, this development could also mean that demand on one of Sweden's important export markets will grow relatively slowly for what may be a long time to come. Ms Ekholm also underlined the fact that the forecast is highly uncertain.

Deputy Governor **Lars Nyberg** began by speaking about financial developments around the world. Since the previous monetary policy meeting in April, conditions on the international financial markets have improved significantly. This is partly due to the fact that the central banks in the USA, the UK and Europe have supported the financial systems in various ways. However, the willingness of private investors to take risks has also increased noticeably. The volumes of issued shares and bonds during the first four months of the year have been much higher than normal on several markets. In recent weeks, interest has also increased in the kind of high-risk securities that have been practically excluded from the market since the autumn of 2008, or even longer. This constitutes more than green shoots. Mr Nyberg believed that it was possible to begin speaking about a lasting turnaround.

The easing of the credit market is positive, but this will not necessarily solve the problems of the banks. Many banks are still regarded by investors as representing a higher risk than their own customers and the banks thus have to pay more to borrow on the market than the customers need to do. In those cases where customers are large enough to have access to the capital markets, they can thus borrow more cheaply than the banks. The fact that investors require the banks to pay more is of course due to the uncertainty regarding future loan losses in the wake of the severe decline in economic activity. There are considerable differences between the banks in this respect. The result is that small and medium-sized companies, which are dependent on the banks, may experience funding difficulties. In Europe, including the UK, where considerable loan losses are still expected, this is a problem. The banks will require large amounts of additional capital in order to be able to supply society with loans when the economic upswing begins. The situation is different in Sweden, but Mr Nyberg wanted to return to this later.

The central banks in, for example, the USA, the UK and Europe have all made great efforts to stabilise the banking systems by providing them with liquidity. As economic activity has rapidly declined and the policy rates have approached zero, the central banks have also, for monetary policy reasons, injected liquidity into the systems by buying government securities and other market-listed assets. At least in the case of the measures taken to promote financial stability, a discussion has now begun on how these can be gradually phased out. In practice, however, it may be difficult to determine which of the measures taken to support liquidity are motivated by the need to promote stability and which are related to monetary policy. On the other hand, perhaps this is not always necessary or meaningful. In any event, there is scepticism on the market about whether the central banks will be able to phase out the measures – and increase policy rates – rapidly enough to prevent the measures driving inflation when the economic upswing begins. There is also anxiety about how the major budget deficits that the crisis has generated in many countries, not least in the USA, can be funded on the market. This scepticism and anxiety tends in the long term to drive up international interest rates for bonds at longer maturities, even though the tendency in recent days has been the opposite.

It remains to be seen whether all the uniquely powerful fiscal policy and monetary policy measures that have been taken around the world will be enough to halt the uniquely rapid and substantial economic downturn we are now experiencing. However, the fact that thought is now being given to how to phase out the measures should naturally be seen against the background of the increasingly numerous and clear signs that we are approaching a turnaround. Expectation variables have developed positively for several months in many parts of the world and the rapid decline in industrial production has slowed down, partly because stocks have gradually been depleted. The stock markets have been surprisingly positive. Mr Nyberg emphasised that in all essentials he shares the view of international developments presented in the draft Monetary Policy Report. In the USA, real housing prices have fallen by a third and are now at the same level as at the turn of the century, which should indicate that we are approaching the bottom of the market in which the crisis has its roots. Unemployment, however, will continue to increase for some time to come and there is a risk that the shortage of capital in the financial system will delay the approaching international upturn.

Deputy Governor **Barbro Wickman-Parak** began by agreeing with Mr Nyberg's description of the stabilisation of the financial markets. Confidence in the financial markets has begun to return and this is an important precondition for the recovery of the real economy.

Ms Wickman-Parak shared the view of the international economic situation presented in the draft Monetary Policy Report. The report describes how GDP continued to fall significantly in most industrialised countries during the first quarter. Not least, this affected the euro area – an area that is important to Swedish exports. Here, GDP fell considerably more than estimated in the forecast in April. However, the report also describes a number of positive signs: world trade has stabilised, the decline in the US economy is slowing down and in the emerging economies in Asia there are signs that economic activity is increasing. The review also shows that the forward-looking indicators have begun to move upwards, although they are still at low levels.

Ms Wickman-Parak said that at the two most recent monetary policy meetings she pointed out the possibility that growth in both Sweden and abroad could be better than expected. This related to developments towards the end of 2009 and 2010. At these meetings, Ms Wickman-Parak drew special attention to the USA and the housing market and the various signs of stabilisation that could be seen there. She did not wish to repeat her arguments at this meeting but noted that the adaptation has continued. Ms Wickman-Parak's assessment was that, within a few quarters, housing investments will make a significant contribution to growth. The adjustment of stocks has also continued and production should begin to increase next year. Orders have ceased falling since the turn of the year. The indicator for orders in the purchasing managers' index has increased steadily since the beginning of the year, and the production indicator has followed.

Ms Wickman-Parak pointed out that she could have mentioned several other positive signs from the USA. Instead, she wanted to add that one should not forget that next year will entail major stimulation measures in the form of structural investments. These should help to boost the situation on the labour market, where the fall in employment has already slowed down somewhat.

The situation in the euro area looks very gloomy and Ms Wickman-Parak supported the view presented in the forecast in the main scenario that growth in the euro area will begin later than in the USA. However, as noted in the draft Monetary Policy Report, the forward-looking indicators have moved upwards in this area too.

Ms Wickman-Parak stated that there is no doubt that we are still in the throes of a severe economic downturn. In such a situation, it is easy to dismiss positive signs by using terms like "green shoots", where it is tacitly understood that these shoots can just as well die out as grow and thrive. Ms Wickman-Parak nevertheless maintained that the fact that the confidence indicators have begun to move in the right direction on a broad geographical front is an important signal at a time when we are experiencing a crisis that is specifically characterised by a lack of confidence on the financial markets as well as among companies and households.

The stock market is not in itself a reliable indicator of economic prospects. However, Ms Wickman-Parak maintained that if, as she believes, the positive signs gain in strength and begin to have an impact on the outcome data this may mean that the stock market will be strengthened in a more lasting way. This in turn will strengthen the households' balance sheets and make it easier for the companies to acquire capital.

For some time now we have seen how the financial crisis has hit the real economy hard. The situation has now eased on the global financial markets and better real economic conditions should in turn have a positive impact on the financial markets - both actual and expected loan losses should decrease.

Many countries have been hit hard and world trade has declined dramatically. The confidence indicators have bottomed out or are rising more or less everywhere. Some countries have, however, made more progress than others. One should not underestimate the potential force of the upswing when more and more countries recover and begin to experience growth.

There are also restraining forces in the growth process, however. The major fall in demand has led to a very low level of resource utilisation and this probably means that investments will only begin to increase when the upturn in production has been underway for a longer period than normal. An important part of demand will thus lag behind the development of the economic cycle. This in turn means that we should probably not expect a strong upswing in growth.

Ms Wickman-Parak concluded by presenting her overall assessment. Growth in the rest of the world will begin to move upwards at the end of this year and during 2010 it will be stronger than in the main scenario. This is not an optimistic forecast but a forecast with a rather moderate upturn. It is, however, closer to the alternative scenario with higher global growth that is presented in the draft Monetary Policy Report.

Svante Öberg noted that there was broad support for the view of international developments presented in the draft Monetary Policy Report among the members of the Executive Board. All of the members saw a clear improvement on the financial markets. There were, however, nuances in the members' views of the development of the real economy, above all in the slightly longer term.

§ 3. Economic developments in Sweden and the monetary policy discussion

Deputy Governor **Lars E.O. Svensson** began the discussion by pointing out that with regard to the lower limit for the repo rate there is a need to differentiate between what is possible and what is desirable from a monetary policy point of view. In the discussion about how far it is possible to lower the interest rate, something of a zero interest rate mystique has arisen which has exaggerated the problems relating to a zero interest rate. The zero interest rate bound does not apply to financial markets; they can handle negative interest rates if necessary. It is the relative prices between financial assets that matter. Interest rates are only one way of expressing relative prices; the price today of kronor tomorrow. If we take a 12-month treasury bill of a nominal value of SEK 100 000, there is no fundamental difference if today it has a price of SEK 99 000, 100 000 or 101 000, which would mean nominal interest rates of approximately 1, 0 or -1 per cent. In other words, there is nothing strange about negative interest rates. Moreover, it is real interest rates and not nominal interest rates that are important when making economic decisions. With an inflation rate of 2 per cent, the real price of 100 000 real kronor in the example above will be SEK 101 000, 102 000 and 103 000, that is the real interest rate will be -1, -2 or -3 per cent. The banks can also use charges to introduce what in reality are negative interest rates on transactional accounts.

The only reason why the concept of a zero interest rate has attracted so much attention is that there are banknotes. Banknotes yield zero interest. If households, companies and investors think that the rate of interest on their accounts is too low they can withdraw cash from these accounts and instead keep large amounts of banknotes in their safes, suitcases and closets. However, taking the handling costs into account, including crime-prevention measures, storage costs and so on, banknotes provide an actual yield that corresponds to a negative interest rate. The lower limit for the interest rate is thus not dependent on the financial markets but is determined by the interest rate at which households, companies and investors would begin to hoard large volumes of cash in the form of banknotes. It is probable that the interest rate could become negative before this happened, but we can not be certain where the lower limit lies. It is, however, possible to draw the conclusion that a policy rate of zero per cent would not necessarily entail any significant problems, especially in the light of experience in Japan, where the policy rate has been 0 and is now 0.1 per cent, in Switzerland, which has a target for the three-month Libor rate of 0.25 per cent and a repo rate of 0.05 per cent, and in the USA, where the federal funds rate is restricted to the interval between 0 and 0.25 per cent.

With regard to the interest rate level that is desirable from the monetary policy point of view, Mr Svensson reminded the meeting that how expansionary or contractionary monetary policy is is determined by four factors: the market's expectations regarding future repo rates, the spreads between market rates and the repo rate (which determine the market rate when the repo rate is close to zero), inflation expectations (which determine the real repo rate and the real market rate) and the real exchange rate (which together with the real market rate determines how expansionary or contractionary monetary policy is).

As mentioned earlier, the risks associated with applying the wrong monetary policy are asymmetrical. The major risk is that monetary policy will be too contractionary, as this is difficult to correct after the event. Considering the four factors presented above, the risks now are that the market's expectations regarding future repo rates will be too high, that the spreads will be too large, that inflation expectations will be too low and that the krona will be too strong. This view was presented in a very instructive way in an article by Ulf Söderström and Andreas Westermark on monetary policy in the event of a zero interest rate in the latest issue of the Riksbank's quarterly publication "Economic Review".

As far as the risk that the krona will be too strong is concerned, Mr Svensson said that he has previously expressed concern about this and about Sweden ending up in a situation similar to that of Switzerland with a strong currency and deflation. He believed, however, that as the krona has continued to be rather weak - recently close to SEK 11 per euro – then a too strong krona is perhaps not such a great risk at the moment.

In the case of the risk that the spreads will be too large, Mr Svensson also noted that these appear to have stabilised so that the spread between the interbank rate and the expected repo rate three months ahead is approximately 0.50 percentage points. It is less in the case of shorter maturities. Higher spreads do not appear to be a specific risk just now and spreads may even decrease further. Spreads are being kept down by the credit easing measures that the Riksbank has taken, that is the Riksbank's lending at various maturities at a variable interest rate, and Mr Svensson believed that these measures should continue.

With regard to the risk that inflation expectations will be too low, Mr Svensson noted that, according to Prospera, inflation expectations for one year ahead are now at 0.7 per cent and for two years ahead at 1.4 per cent, that is at an average of 1.05 per cent for the next two years. In April, this average for the first two years was 1.2 per cent, so inflation expectations have fallen somewhat since April. An econometric analysis of inflation expectations indicates that they are lower than usual given actual inflation, but that the deviations are nevertheless smaller than they were in April.

Inflation expectations are lower than the Riksbank's own forecast for CPI inflation, which is now 1.2 per cent for the first four quarters and 3.2 per cent for the next four quarters, that is an average of 2.2 per cent for the next two years. This means that the inflation expectations of 1.05 per cent for the next two years are almost 1.2 percentage points lower than the Riksbank's inflation forecast. The gap between inflation expectations and the Riksbank's inflation forecast has also increased since April, when it was 0.6 per cent for the next two years. For a given repo rate path this entails a higher real repo rate path for the next two years and thus a more contractionary monetary policy than is assumed in the draft Monetary Policy Report.

The remaining risk that monetary policy will be too contractionary is that market expectations regarding the future repo rate path will be too high. Mr Svensson pointed out that one of the most important insights gained from monetary policy theory and practice in recent years is that monetary policy mainly, perhaps almost solely, works through expectations regarding future interest rates, inflation and the real economy. Setting the repo rate and publishing the repo rate path thus mainly affect inflation and the real economy by way of the expectations of future repo rates that arise. What the repo rate will be over the next two months plays almost no practical role at all. It is instead what companies, households and financial market participants believe about the repo rate over the next few years that matters.

The main aim of publishing a repo rate path is to influence the expectations of households, companies and the market regarding the future repo rate path, as a former member of the Executive Board, Irma Rosenberg, explained in a speech in 2007 in connection with the introduction of the repo rate path. The extent to which market expectations actually adapt to the published repo rate path is thus very important. Mr Svensson referred to an essay he wrote about this in a previous issue of the Riksbank's "Economic Review" and to updated data and diagrams on his website. Up to February 2009, the repo rate path had a high level of credibility in the sense that market expectations following publication corresponded fairly well with the repo rate path. In many cases, expectations were already prior to publication in line with the repo rate path, which is a tribute to the ability of the market to predict and understand monetary policy and to the Riksbank's ability to conduct a predictable policy.

The major exception is April 2009, when the market expected the repo rate to be cut to 0.25 per cent. The repo rate was actually cut to 0.50 per cent. Since then, the market has expected a repo rate path that after a few quarters will be significantly above the published repo rate path. This is the way it has looked from the first day following publication. The credibility of the repo rate path published in April is thus very low and the Riksbank has failed to bring repo rate expectations into line with the repo rate path.

Mr Svensson wondered about the reasons for this failure and said that his own thinking and his discussions with market participants have led him to conclude that the best explanation is that the Riksbank's communication was contradictory at and following the monetary policy meeting in April. The forecasts that the Riksbank publishes are all mean forecasts, including the repo rate path, as we heard earlier. Given this, the Riksbank usually stresses that the repo rate path is a forecast, not a promise. The future repo rate may be above as well as below the repo rate path. However, the Monetary Policy Update and the minutes from April have been widely interpreted to mean that 0.50 per cent was a minimum for the repo rate and thus a promise that it would not be lower. Statements by several members of the Executive Board have also been interpreted to mean that the repo rate may be increased sooner than indicated by the published repo rate path. In such circumstances it is not surprising if the Riksbank fails to gain credibility for the repo rate path.

If there is a difference between the repo rate path that the Riksbank publishes and the path that the market expects, it is the expected path that counts. It is the expected repo rate path that, through the spreads, affects what the actual market rates at different maturities will be and that thus affects the real economy. All else being equal, an expected path that is higher than the published path means that the actual monetary policy will be more contractionary than intended. All else being equal, the actual real interest rates will be higher than the real interest rates presented in the draft Monetary Policy Report. A true forecast for inflation and resource utilisation that takes account of this discrepancy will thus be lower than that in the draft Monetary Policy Report.

An analysis of the consequences of market expectations of future inflation and/or repo rates differing from the Riksbank's forecasts in the Monetary Policy Report requires that the apparatus used for the analysis can handle non-rational expectations. Mr Svensson maintained that it would be desirable for the Monetary Policy Department to develop methods that can handle such expectations and that can also differentiate between actual and intended monetary policy.

It has been said that the high repo rate expectations are not necessarily a problem if they are based on a more optimistic assessment of the future development of the economy. Mr Svensson agreed that this could be so if it were the case that this optimistic assessment led to inflation expectations being higher. In such a case, the actual real interest rate would not be higher. However, as he pointed out earlier, actual inflation expectations are lower than the Riksbank's inflation forecast, not higher. The actual real interest rate will therefore be higher, not lower, than the level assumed in the Monetary Policy report, and the actual monetary policy will be more contractionary than the intended policy.

Overall, the repo rate path expected by the market was on average approximately 0.6 percentage points higher for the first two years than the Riksbank's repo rate path in April. At the same time, inflation expectations are approximately 1.2 percentage points lower for the first two years than the Riksbank's inflation forecast in the draft Monetary Policy Report. Assume that the difference between the expected and published repo rate is as large now in July. This means that the real repo rate path will on average be approximatery 1.8 per cent higher during the first two years than the real repo rate path assumed in the draft Monetary Policy Report. This is a big difference and means that the actual monetary policy is considerably more contractionary than the policy assumed in the report. If this is taken into account, a more correct forecast for inflation and resource utilisation will be significantly lower than the forecast in the draft Monetary Policy Report.

Mr Svensson believed that the Riksbank should do all that it can to bring repo rate expectations down towards the repo rate path. Better communication would help with this, primarily in the form of a clarification that the repo rate path should be seen as a mean forecast. This means that both increases and reductions are possible and is thus not compatible with a promise that there will be no further cuts in the repo rate. Lending at longer maturities at a fixed interest rate is probably also an effective way of influencing repo rate expectations.

Deputy Governor **Karolina Ekholm** said that her assessment of the situation had not significantly changed since the previous monetary policy meeting. We are experiencing a deep recession which is keeping resource utilisation low and thus dampening inflation pressures too. There are several signs that the downturn has slowed down and that a turnaround in economic activity is approaching, but so far these signs largely relate to forward-looking indicators that pinpoint the expectations of households and companies regarding future developments. In the published data, there are as yet no clear signs of a turnaround.

Ms Ekholm believed that the assessment in April that a very low interest rate would probably be needed for a long period of time is still valid. The new information that has become available and that is of relevance to Ms Ekholm's stance is that it is probably possible to further reduce the repo rate somewhat without significant costs arising in terms of disruptions on the financial markets. The cut from 1 per cent to 0.5 per cent in April took place without causing any measurable problems and the studies conducted by the Riksbank indicate that a reduction by a further couple of tenths of a percentage point can also be made without causing significant problems. Ms Ekholm said that she therefore supports the proposal to cut the repo rate by 0.25 percentage points to 0.25 per cent.

With regard to the repo rate path, Ms Ekholm believed, as she pointed out earlier, that the assessment that there may be a need to keep the repo rate at this low level for some time to come still applies. It may naturally be the case that the global economy recovers more rapidly than assumed in the forecast in the main scenario. If so, it will also be necessary to increase the repo rate more rapidly, as presented in one of the alternative scenarios. Ms Ekholm's assessment was, however, that recovery will be slow, as outlined in the report's main scenario. She also pointed out that although there has been some degree of normalisation on the financial markets these are still not functioning entirely normally and events may occur that lead to new disruptions. The effects of the major fiscal policy stimulation measures may also be limited by the deterioration of public finances.

In Sweden's case, the recession may lead to a structural transformation that is more extensive than usual and that means it will take time before the resources that become available can be put to use again.

Ms Ekholm pointed out that despite all the talk about the post-industrial society, Sweden still largely pays its way by selling vehicles and machinery to consumers and companies in other prosperous countries. The fall in the demand for vehicles and investment goods has hit Sweden particularly hard. In the short term, there is not much that monetary policy can do about the decline in demand apart from keeping the interest rate low and thus trying to help to stimulate investment and domestic consumption. Ms Ekholm also pointed out that Sweden may face structural changes where some industrial sectors fail to recover when the economic upswing comes. It may be the case that the demand for Swedish exports has fallen in a more lasting way, which as Mr Svensson pointed out may lead to a deterioration in the terms of trade. This may also mean that it will take longer for the resources now made available in the manufacturing industry to be put to use once again compared with what is normally the case in a recession. People who lose their jobs may not have the skills or expertise that will be in demand when the economic situation improves and employment increases once again. Ms Ekholm said that this may justify the negative view of the development of the supply of labour that forms the basis for the forecast in the draft Monetary Policy Report despite the fact that there have been a significant number of reforms in the field of labour market policy that aim to increase the supply of labour. Ms Ekholm believed that it is probable that it will be necessary to keep the repo rate at a low level for some time to come.

First Deputy Governor **Svante Öberg** supported the forecasts for the Swedish economy presented in the draft Monetary Policy Report. Mr Öberg therefore wished to limit his comments to discussing the risks in the forecast. His assessment was that the risks are balanced in the case of both international and Swedish developments.

The major risk on the downside is that the recovery following the financial crisis may take longer as the result of the adaptation of various participants' balance sheets. An additional factor in Sweden's case is that developments in the Baltic countries are problematic. A worsening of the crisis in the Baltic countries would have serious consequences for the Swedish banks and also affect the Swedish economy.

However, there is also a possibility that the turnaround will come sooner than expected. Certain economic indicators have already bottomed out or have begun to rise. So far, this is more an expression of a decreasing pessimism than increasing optimism. Economic policy is highly expansionary in large parts of the world and may have a greater impact on demand than estimated. This may result in a rapid increase in resource utilisation and higher inflation.

To summarise, Mr Öberg said that his assessment was that the worst is over. Recovery will however be slow, as outlined in the draft Monetary Policy Report, and the risks are balanced.

Mr Öberg supported the proposal to cut the repo rate by 0.25 percentage points to 0.25 per cent. The information received since April indicates that it is possible to reduce the repo rate to 0.25 per cent without tangibly disrupting the functioning of the financial markets. Mr Öberg believed that even though a reduction of 0.25 percentage points from the current low level will probably not have such a great impact, it is still worth making the cut. His assessment was that with today's cut the repo rate has in practice reached its lower limit and that it should not be reduced more than this.

Mr Öberg also supported the proposed interest rate path. It is probable that the repo rate will need to remain at a low level for a considerable period of time. It is not easy to determine how long this period should be. It is important not to begin tightening monetary policy too early, or too late. Mr Öberg's assessment was that it will become necessary to begin raising the repo rate in approximately a year's time.

If the crisis continues for longer than expected, it may become necessary to continue keeping the repo rate at a low level and to proceed with more unconventional measures. If the recovery is faster than expected, it may be necessary to begin increasing the repo rate sooner. This applies particularly if during the course of next year it is possible to see signs of a strong recovery in 2011 and onwards.

Mr Öberg also said that he supported the proposal to lend up to SEK 100 billion for 12 months at a fixed interest rate. His assessment was, however, that it is not probable that this will have any major positive effects. The Riksbank already provides 12-month loans at a variable interest rate, so any positive effects must arise from the fact that the banks will not need to take account of the risk that we will increase the interest rate over the next 12 months. However, lending at a fixed interest rate should not in any case have any negative effects. With a supplement of 0.15 percentage points on the repo rate, there is little risk that the costs to the Riksbank will be greater than the revenues.

Mr Öberg also pointed out that lending at a fixed interest rate does not affect the view of what the repo rate path entails. He believed that the Riksbank should continue to maintain that it is a forecast and not a promise.

He also believed that in the future the Riksbank needs to devote more time and energy to analysing how the repo rate interacts with asset prices and the expansion of credit with regard to the effects on GDP growth and inflation.

Deputy Governor **Barbro Wickman-Parak** said that in the case of Sweden too the description of the current status of the economy in the draft Monetary Policy Report corresponds to her own assessment of the situation. The economic downturn has been deep and rapid and we have seen nothing like the present fall in GDP since the Second World

War. The draft Report also contains many illustrative diagrams that show that economic activity has stabilised and that the forward-looking indicators have, as abroad, begun to move upwards, even though they are still at low levels.

Ms Wickman-Parak reminded the meeting that her assessment of the international economic outlook is more positive. This supports the belief that exports will develop better than predicted in the main scenario. That such a development may be underway is supported by the fact that the fall in export orders has slowed down, which also applies to exports according to the foreign trade statistics. The business confidence survey of the National Institute of Economic Research shows that the number of companies that expect to see a continuing fall in exports has decreased rapidly in recent months. With regard to the survey, it can also be added that the confidence indicator for the business sector has risen three months in a row, although it is still at a low level. It is interesting to note that all of the sub-sectors contribute to this upturn.

Ms Wickman-Parak also said that her assessment was that household consumption may develop more rapidly than in the main scenario despite the continued rise in unemployment. The incomes of those in work have developed well and the level of saving is initially high. The confidence indicator for the households has begun to rise and in the last few months there has been a significant positive shift in the households' views of the Swedish economy over the next 12 months. The view of the labour market one year ahead has also brightened. The figures for retail trade turnover in the last few months indicate that there has been a slight recovery in household consumption and it can be noted that the confidence indicator for the retail trade has recovered rapidly.

The situation on the labour market is very gloomy, as can clearly be seen in the draft Monetary Policy Report. When a small, open economy is hit by an abrupt downturn in export demand, employment also suffers. This is something that the very radical repo rate cuts have not been able to prevent. Ms Wikckman-Parak also believed that employment is a variable that is lagging behind. Although she expects production to increase more than predicted in the main scenario of the draft Monetary Policy Report, she nevertheless believes that unemployment will rise, although to a slightly lesser extent than predicted in the main scenario.

Ms Wickman-Parak pointed out that the Riksbank's forecasts must be based on an assumption regarding fiscal policy. In the maion scenario, it is expected that fiscal policy will be less expansionary than is usually the case in a downturn. This is based on the government's clear statement that it is necessary to safeguard public finances. Considering that next year is an election year, Ms Wickman-Parak believed that it is nevertheless quite likely that more stimulation measures may be taken then, as is usually the case. The economic situation in the local government sector is under pressure and it is reasonable to expect that allocations to this sector will increase. Ms Wickman-Parak said that fiscal policy measures normally have a greater impact on employment than monetary policy, which acts generally and moreover, in the present situation, does not have a lot left to offer.

She summed up by saying that her view of growth prospects in Sweden in the longer term is more positive than the view presented in the main scenario. Capacity utilisation is low, however, and it will take some time before investment also begins to increase so that the upturn becomes more fully fledged.

With regard to the monetary policy decision, Ms Wickman-Parak said that her assessment has been that the repo rate should be kept at 0.50 per cent and that she is now more certain than previously that a turnaround in the economy has begun. She also believed that it has not yet been possible to observe the full effects of the radical repo rate cuts that have been made previously.

Ms Wickman-Parak made it clear that even if a majority supported the current proposal for a repo rate cut to 0.25 per cent, it would under normal conditions have been natural for her not to support such a decision given that she has a more positive view of growth. However, she said that the present situation is not normal, that she is aware of the severity of the downturn and that her view of the current status of the economy and of developments in the period immediately ahead does not diverge significantly from the main scenario. Nor did she believe that it was of any decisive importance whether the repo rate is 0.25 per cent or 0.50 per cent, which she pointed out already at the previous monetary policy meeting. However, given the strained economic situation Ms Wickman-Parak said that it can do no harm to reduce the repo rate even though the impact on the real economy will be limited, especially as there is no risk of inflation in the short-term perspective.

Ms Wickman-Parak also explained that she shared the view of the other members of the Executive Board concerning the proposal to provide loans to the banks at a fixed interest rate. She was uncertain about the impact this measure may have in the form of lower interest rates for households and companies, but any effect should be a positive one.

To sum up, Ms Wickman-Parak declared that in the event that a majority of the members of the Executive Board were in favour of reducing the repo rate then she was prepared to support this and also to support the provision of loans at a fixed interest rate. This stance was based on her view that as no one can be certain as yet that financial stability is resting on firm foundations there is a value in reaching a certain degree of unanimity concerning the immediate measures.

With regard to the medium-term perspective and the repo rate path, Ms Wickman-Parak repeated that she has a different view of the economic prospects than that expressed in the main scenario. She could not therefore support the repo rate path incorporated in this scenario. According to this repo rate path, it will be possible to begin increasing the repo rate in the autumn of 2010, while Ms Wickman-Parak's assessment is that it will be necessary to begin increasing the repo rate earlier, perhaps during the late spring or the summer of 2010. In line with this assessment, not only will we see the beginning of an upturn by then, there will also be an improvement in growth prospects. However, employment will continue to fall for some time to come.

Ms Wickman-Parak said that the discusion was often limited to changes in the repo rate but that the level of the repo rate should not be ignored. The current repo rate is extremely low and is in her eyes "a crisis rate". She believed that the normalisation of the repo rate must begin before the upturn reaches such a level that its effects begin to become apparent on the labour market. The increases can then be made gradually to give the households and companies the opportunity to adapt to a situation with higher interest rates. In this situation, it must be taken into account that the decisions to increase the repo rate will not be popular.

Ms Wickman-Parak also believed that it may become necessary to deal with an inflation picture that is different to the situation today. Once 2009 is at an end, we will have experienced three years with rising cost pressures and when the economy strengthens there is a risk that the development of costs to date will have a greater impact on prices, even though cost pressures are expected to weaken in the period ahead. She also repeated her warning from the previous monetary policy meeting concerning a greater increase in commodity prices than predicted. The draft Monetary Policy Report shows that not only the oil price but also the prices of other commodities have increased in recent months. Nor can we be sure that productivity will recover as predicted or that the krona will strengthen as expected. In conclusion, Ms Wickman-Parak said that it may be so that the expansionary policy now being conducted abroad may push up international inflation with a risk of increased imported inflation. It can also be noted that anxiety about deflation in, for example, the USA has now petered out and has been replaced by a certain amount of concern about inflation.

Deputy Governor **Lars Nyberg** said that the Swedish banks are not experiencing the same shortage of capital as banks in many other parts of the world. Lending to households and companies has continued to increase measured as rolling 12-month figures, although at a slower pace than previously. The fact that lending to companies has declined in recent months is probably a consequence of the lack of demand for loans, not because the banks have tightened their lending. The surveys that have been carried out indicate that it has hardly become more difficult for the companies to borrow than during a normal downturn, when credit conditions are always tightened somewhat. During the spring, it appears rather that the supply of credit has increased. Even though loan losses will increase in the Swedish banks too, there is nothing to indicate that a shortage of capital, and thus of lending capacity, will be an obstacle to the approaching upturn as is feared in other parts of the world.

In Sweden, it is the decline in the demand for our exports, which directly and indirectly leads to rapidly increasing unemployment and falling capacity utilisation, that represents the major problem for both fiscal policy and monetary policy. The weak krona has mitigated this problem somewhat in the short term, but basically we are dependent on the recovery of real demand abroad. There are no Swedish political measures that can affect this. We will have to wait. However, sound public finances and an effective banking system mean that our situation will be better than that of many other countries when the upturn does come. And in Sweden too, clear positive signals are emerging with regard, for example, to expectation variables and turnover in the retail trade. Tax relief and falling interest costs have helped to keep consumption up – for those who have jobs.

What can be done through the medium of monetary policy to stimulate domestic demand has, by and large, already been done. The rapid and substantial cuts in the repo rate have helped to keep up turnover and prices on the housing market longer than in other countries and longer than normal in the economic cycle. The fact that Sweden did not initially have the same price bubble as many other countries has also helped. Mr Nyberg said, however, that it is difficult not to believe that increasing unemployment will eventually lead to a decline in demand and falling prices on the Swedish housing market too.

Mr Nyberg supported the proposal to cut the repo rate by 0.25 percentage points to 0.25 per cent and said that following discussions with market participants he is certain that this can be done without seriously affecting trading on the short-term market. He pointed out that the fact that the initial situation is worse than the assessment at the previous monetary policy meeting in April is also important. Mr Nyberg did not believe, however, that the effects of a further cut will be particularly significant in the short term; it is the lack of demand rather than the cost of funding that is holding investment back at present. However, it is reasonable to expect that the effects of a cut will be positive rather than negative. On the other hand, Mr Nyberg was not in favour of making any further cuts in the repo rate. He believed that a broad margin should be maintained to a situation in which there is a risk that consumers will have to pay the banks interest or charges for having money in their deposit accounts. Mr Nyberg said that it would be an unfortunate development if people were to begin considering keeping their money in their mattresses rather than in the bank.

He emphasised, on the other hand, that it is important in the current situation that the Riksbank clearly signals that it sees a low repo rate for a number of quarters ahead. This can have a positive impact on the investment decisions of both companies and households. The repo rate path incorporated in the forecast sends precisely this kind of signal. Inflation is not a serious problem in the short and medium terms and Mr Nyberg maintained that in the current situation inflation does not constitute a restriction on monetary policy when it comes to strengthening the real economy. When the turnaround does come, however, there will of course be a need to increase the repo rate. This is also taken into account in the repo rate path, but may be worth pointing out nevertheless.

Mr Nyberg wondered whether the Riksbank needs to do more and can do more to try to strengthen the Swedish economy. He believed that it was not possible to give a 100 per cent positive answer to either of these questions. Monetary policy is already highly expansionary with a real interest rate that is lower than in many other countries. Other central banks have tested different types of quantative stimulation, either with the aim of squeezing the slightly longer-term interest rates on the market somewhat or to increase the money supply and thus also perhaps affect the supply and price of credit. It is too early to evaluate how effective these measures have been. The countries that are testing quantitative measures also have more serious problems than Sweden in many ways, not least in their domestic financial systems. Mr Nyberg said that in his view it is not obvious that quantitative stimulation measures are needed in Sweden.

What can be done to complement the reduction of the repo rate, if this is now desirable? Sweden has a bank-based rather than a market-based financial system. Measures that directly aim to influence the slightly longer-term interest rates in the banking system may therefore be preferable to measures that more indirectly affect the market, for example buying government securities. Mr Nyberg said that he could support the proposal to temporarily increase lending to the banks at a fixed interest rate. This is a natural complement to the longer loans at variable rates that the Riksbank already provides. Both can reasonably be expected to contribute to an increase in credit capacity in the banking system and may perhaps help to reduce the steep upward incline of the market's interest rate curve. They also thus support the repo rate path, which is flatter than the path that has figured in the market's expectations to date. The fact that the market has not shared the same view of interest rates for the year ahead as the Riksbank has of course made monetary policy less expansionary than intended. It can also do no harm, given that the international financial markets are still uncertain, if the banks can gain access to longer-term funding—even if the funding comes from the Riksbank. Mr Nyberg said that it is difficult see any significant disadvantages in lending money to the banks at a fixed interest rate to a limited extent. Whether this will have any positive effects, other than in the short term, remains to be seen.

With regard to the decision on the repo rate and the repo rate path, Deputy Governor **Lars E.O. Svensson** pointed out that the draft Monetary Policy Report offers a menu of alternatives to choose between. In order to constitute a good basis for decisions, every draft Monetary Policy Report should provide a number of possible and relevant monetary policy alternatives. Three alternative scenarios with different repo rate paths are presented on page 24, with red curves for the main scenario with a repo rate path that begins with a reduction to approximately 0.25 per cent, yellow curves for a high repo rate scenario with a repo rate path that remains at approximately 0.50 per cent, and blue curves for a low repo rate scenario with a repo rate path that begins with a reduction to 0 per cent.

Monetary policy aims to stabilise inflation around the inflation target and to stabilise resource utilisation at a normal level. A well-balanced monetary policy is thus a reasonable compromise between these two aims. Figure 31 shows the forecast for the labour market gap for the three alternatives and Figure 32 shows the forecast for the CPIF for the three alternatives.

With regard to stabilising the CPIF around the inflation target, Mr Svensson said that the higher repo rate alternative is slightly worse while the other two alternatives are equal. The deviations from the inflation target are actually so small that they are of no practical importance. However, with regard to stabilising resource utilisation, Mr Svensson said that the differences are very clear. The main scenario entails better resource utilisation than the high repo rate scenario, and the low repo rate scenario provides better resource utilisation than the main scenario. Mr Svensson therefore believed that the decision was simple. The low repo rate alternative provides better resource utilisation and an equally good level of CPIF inflation. The low repo rate scenario entails a labour market gap that is approximately 0.5 percentage points better than the gap in the main scenario. This is equivalent to saving around 25 000 jobs during the forecast period. Saving 25 000 jobs will also have a much greater impact on social welfare when unemployment is 10 to 11 per cent than in a situation with normal employment levels, as in periods of high unemployment it is more difficult to find new jobs, the periods of unemployment are longer and the risk of exclusion from the labour market is higher.

Mr Svensson also said that there is actually reason to believe that the impact of cutting the repo rate from 0.50 to 0 per cent can be twice as great as cutting it from 0.50 to 0.25 per cent. The reason for this is that, as mentioned earlier, repo rate expectations are higher than the repo rate path and it is reasonable to assume that these will move down in proportion to the reduction of the repo rate path. Any potential negative effects on the functioning of the financial markets are in this context of lesser importance compared to the advantages of higher resource utilisation and lower unemployment.

Mr Svensson summed up by saying that the low repo rate scenario in the draft Monetary Policy Report constitutes a better-balanced monetary policy than the main scenario. It is also preferable from a risk-management perspective. As mentioned earlier, the risks are asymmetrical when the repo rate is close to its lower limit. If monetary policy becomes too expansionary it is easy to correct this later by increasing the repo rate path. A monetary policy that becomes too contractionary is, on the other hand, much more difficult to correct. If one is to err, it is therefore better to err on the side of expansion as this is easy to correct later.

Mr Svensson thus advocated the repo rate path presented in the low repo rate scenario in Figure 30 in the draft Monetary Policy Report. He also supported the proposal to offer loans at a fixed interest rate with a maturity of 12 months.

Deputy Governor **Karolina Ekholm said** that at the monetary policy meeting in April it was discussed whether there was a need to complement monetary policy with other, unconventional measures of some sort. Ms Ekholm's assessment was that such a need now prevailed and, like the other members of the Executive Board, supported the proposal to offer SEK loans at a fixed interest rate. This measure can support the monetary policy that is adopted by the Executive Board and which forms the basis for the forecasts, and can thus help the policy to have the intended effect. Ms Ekholm pointed out that there is a fairly high degree of uncertainty about the effects such a measure may have on the interest rates met by households and companies. However, like Ms Wickman-Parak, Ms Ekholm noted that any effects are likely to be positive rather than negative and it is therefore worth testing this measure.

With regard to the repo rate path, Ms Ekholm emphasised that in her view the repo rate should not be reduced beyond 0.25 per cent despite the fact that the alternative scenario with a zero interest rate described in the report entails a slightly better level of resource utilisation. Ms Ekholm said that she was not as convinced as Mr Svensson that the effects of repo rate cuts are linear at the low level that the repo rate is now at. The draft Monetary Policy Report also points to the risk that the effect on resource utilisation will not be as great as the Figure on the forecast for the labour market gap indicates. Ms Ekholm believed that a reduction to 0.25 per cent represented a substantial monetary policy stimulation measure. The repo rate is at its lowest ever level. Ms Ekholm said that she found it difficult to assess how the economy would be affected by an even lower repo rate. She believed that it is important to have a certain safety margin to avoid the risk that unforeseen effects will arise so that the repo rate cut hinders rather than helps the recovery of the economy.

First deputy Governor **Svante Öberg** said that he wished to comment on two issues raised by Mr Svensson. The first concerned the balance of monetary policy and the second the view of the repo rate path.

Monetary policy is now highly expansionary. Underlying inflation and inflation expectations in the longer term are, with this orientation of monetary policy, close to the inflation target of 2 per cent. The rapid and substantial reduction of the repo rate since September also supports production and employment. The real repo rate in Sweden is now -1.5 per cent and is expected to be negative until the second quarter of 2011. Mr Öberg explained that he was talking about the repo rate deflated with the forecast for the CPI with a fixed mortgage rate, the CPIF. He also pointed out that the krona has weakened, which reinforces the stimulation provided by monetary policy. In his opinion, this was a well-balanced monetary policy in line with the mission that the Riksbank has been given by parliament.

The present crisis is so severe that resource utilisation will be low for some time to come. But monetary policy can not eliminate a recession. What one can do is to conduct an expansionary monetary policy in order to reduce the severity of the recession. This is also what the Riksbank is trying to do.

When considering a possible further cut in the repo rate one must take into account that the positive effects of a cut will probably be weaker at the current low repo rate levels and that the costs in the form of less effective money markets will probably be higher the lower the repo rate is.

Mr Öberg also pointed out that monetary policy is much more expansionary in Sweden than in the euro area. Real interest rates are lower in Sweden than in the euro area. The nominal interest rates are lower and inflation is higher. In addition the krona is weak, which strengthens the expansionary effect. The present interest rate profile entails that real interest rates in Sweden and abroad are expected to begin increasing in the third quarter of 2010. This appears reasonable given the current forecasts.

Mr Öberg also said that it is not particularly strange that expectations regarding the repo rate path one or two years ahead, as they can be detected in market pricing, are above the repo rate path. First, the repo rate is close to zero and in practice uncertainty lies solely on the upside. Second, the level of uncertainty is unusually high at the moment. The Riksbank has substantially altered the forecasts for the repo rate over the last 12 months. It is reasonable that the credibility of the repo rate path is lower under the current exceptional circumstances. In September last year, the forecast was that the repo rate now in July would, with a probability of 95 per cent, be higher than 3.5 per cent.

Mr Öberg said that his view of the repo rate path is that it represents the most probable development of the repo rate, but that uncertainty is in practice solely upwards. In a technical sense this means that the repo rate path for the year ahead is a typical value rather than a mean value. Forecasts are always uncertain. In the present situation, with the repo rate so close to zero, a number of theoretical and practical problems also arise. However, Mr Öberg believed that the uncertainty this adds is marginal compared to the uncertainties that are always associated with forecasting.

Deputy Governor **Barbro Wickman-Parak** also took up the discussion of the expectations regarding the repo rate in relation to the repo rate path. She said that the period available for comparisons since the repo rate path was introduced in 2007 is rather short. Experience of how the expectations usually differ from the repo rate path in different situations is therefore limited. At present, economic activity is hanging in the balance and a lot has happened since the forecast in April. There is therefore nothing strange about the fact that the market participants' assessment of the growth prospects, and thus the repo rate path, may have changed. This is something we have to live with.

Deputy Governor **Lars Nyberg** said that he shared Mr Öberg's view that Sweden has a highly expansionary monetary policy compared to the euro area. One can not expect monetary policy to compensate for the effects of the fall in export demand to the extent that one can in large countries like Japan or the USA. Mr Nyberg believed that the proposal to cut the repo rate to 0.25 per cent can be regarded as representing a well-balanced monetary policy.

Deputy Governor **Lars E.O. Svensson** found it regretable that there is once again a risk that the Riksbank's communication regarding the repo rate path will be contradictory and unclear, as a statement that the repo rate has reached its lowest limit conflicts with the fact that the repo path is a mean forecast and will lead to the mean being higher.

He stressed that if one attaches any importance to the stabilisation of resource utilisation then it is reasonable to prefer the low repo rate scenario to the main scenario as this entails a lower level of unemployment without undermining the stabilisation of CPIF inflation. He thus continued to advocate a larger cut in the repo rate and a repo rate path in line with the low repo rate scenario.

Mr Öberg then summarised the monetary policy discussion. Economic activity abroad is very weak and this hits Sweden hard. Exports have fallen substantially and the situation on the labour market is continuing to deteriorate rapidly. The information received in recent months points to the economic downturn in 2009 being somewhat deeper than the Riksbank's forecast in April. A lower repo rate and repo rate path are needed to counteract the fall in production and employment and to attain the inflation target of 2 per cent. The repo rate is expected to remain at this low level until the autumn of 2010. The assessment is that cutting the rate to 0.25 per cent will not threaten the functioning of the financial markets.

Mr Öberg also noted that the assessment of a majority of the members of the Executive Board is that, following the reduction to 0.25 per cent, the repo rate has reached its lower level, that the situation on the financial markets is still not completely normal and that complementary measures are needed for monetary policy to have the intended effects. The Riksbank should therefore offer loans totalling SEK 100 billion to the banks at a fixed interest rate and with a maturity of 12 months. This should contribute to lower interest rates on loans to companies and households. A decision on this will be made under a later point on the agenda.

In recent months there have been several signs that economic activity will improve. At the same time, the financial markets in Sweden and abroad have begun to function more effectively, which creates the potential for an acceleration in international and domestic demand. The low repo rate and current fiscal policy will also contribute to the recovery. GDP growth is expected to be positive in 2010, but the labour market will lag behind and employment will not begin to rise until 2011.

Inflation is being kept up by weak productivity and a weak krona. However, there will be large fluctuations in CPI inflation during the coming period. This is primarily due to the fact that changes in the repo rate affect mortgage rates, which are included in the CPI. Underlying inflation measured in terms of the CPIF will, on the other hand, remain stable at a level close to 2 per cent during the forecast period.

The economic outlook is still uncertain. When the turnaround comes, the upturn may be stronger than in the main scenario. However, it could also be the case that the recovery will take longer than expected. The future direction for monetary policy will therefore depend on how new information on economic developments abroad and in Sweden will affect the prospects for inflation and economic activity in Sweden.

§ 4. Monetary policy decision

The Chairman noted that there was a proposal to cut the repo rate by 0.25 percentage points and a proposal to cut the repo rate by 0.50 percentage points.

The Executive Board decided after voting

- to adopt the Monetary Policy Report according to the proposal, Annex A to the minutes,
- to publish the Monetary Policy Report on Thursday 2 July at 09.30,
- to cut the repo rate by 0.25 percentage points to 0.25 per cent and that this decision would apply from 8 July 2009,
- to cut the lending rate to 0.75 per cent and the deposit rate to -0.25 per cent, with effect from 8 July 2009,
- to announce the decision at 9.30 a.m. on Thursday 2 July 2009 with the motivation and wording contained in Press Release no. 67 2009 (Annex B to the minutes), and
- to publish the minutes of today's meeting at 9.30 a.m. on Thursday, 16 July.

Deputy Governor Lars E.O. Svensson entered a reservation against the decision and advocated cutting the repo rate to 0 per cent and a repo rate path in line with the scenario for a lower repo rate in the Monetary Policy Report, so that the repo rate would be kept at this level for one year. He considered that such a repo rate path entails a better balanced monetary policy, with lower unemployment and higher resource utilisation without inflation deviating too far from the target.

Deputy Governor Barbro Wickman-Parak supported the decision to cut the repo rate to 0.25 per cent, but entered a reservation against the growth forecasts, and thereby the repo rate path these entailed, in the Monetary Policy Report. Ms Wickman-Parak said her stance was due to a more positive view of economic activity both abroad and in Sweden further ahead, which would mean that the repo rate would need to be raised earlier than is forecast in the main scenario of the Monetary Policy Report.

This paragraph was confirmed immediately.

Minutes by

Ann-Christine Högberg

Checked by:

Karolina Ekholm	Lars Nyberg	Lars E.O. Svensson
Barbro Wickman-Parak	Svante Öberg	